June 2003

DECENTRALIZATION AND LOCAL GOVERNMENT BORROWING IN INDONESIA

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I. Introduction

For much of its recent history, Indonesia's constitutional arrangements had established it as a multi-tier unitary state, with provinces as the second tier below the central government and local governments as the third tier. The centralization of authority in Jakarta was justified as a way of maintaining national unity in a nation of over 200 million people, spread across 14,000 islands and 2 million square kilometers; it was also in part a counter reaction to efforts by a previous colonial power, the Dutch, to assert the importance of federalism as a last effort to control the newly independent Indonesia. In May 1999, however, the Government of Indonesia (GOI) started a major program of governmental decentralization with the passage of two laws on various aspects of decentralization, Law No. 22/1999 on Regional Government (UU PD) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD). The implementation of these laws began in January 2001, and has already begun to transform intergovernmental fiscal relations in Indonesia.

One aspect of this decentralization that has been largely unexamined is its potential impact on local government borrowing. If local governments are given more independence in their tax and expenditure decisions, such independence may well extend to their use of borrowing. There is little question that, in principle, local government access to capital markets can provide significant benefits. Local governments can use borrowing to better match current expenditures with current tax revenues, allowing temporary and unexpected swings in revenues to be smoothed without undue disruption in service provision. More importantly, local governments can use borrowing to finance public capital projects that are lumpy in nature; finance of investment projects via current revenues is likely to be inefficient, and, since future generations will benefit from long-lived projects, finance via current revenues collected from current generations is likely to be inequitable as well. According to the well-known "principle of subsidiarity", the responsibility for the provision of government services should be at the lowest level of government compatible with the benefit area of the service, since decisions made by a level of government that is closer to its constituency are likely to reflect more closely the wishes of the voters. This principle applies equally to capital expenditures, as well as to current expenditures: local governments should take full responsibility for planning, financing, and executing all capital projects whose benefit area corresponds with the geographic area of the jurisdiction.

However, there is also little question that local government borrowing has sometimes created, or at least contributed to, significant problems.[1] When local governments are given preferential access to capital markets, they may be encouraged to undertake capital projects whose economic justification is weak. More importantly, when local governments are unable to repay their loans, the central government may be forced to assume responsibility for the debt service. If widely anticipated, this may in turn lead lenders to act imprudently by lending to local governments that are not creditworthy, it may encourage local governments to borrow excessively, and it may create unplanned and uncontrollable fiscal liabilities for the central government. There is compelling evidence that decentralization has in fact contributed to macroeconomic instability, in countries like Brazil, China, and Colombia.[2]

In this paper, we examine the decentralization reforms now underway in Indonesia, focusing on their effects on local government borrowing. Our general conclusion is that the laws and their implementing regulations seem designed mainly to deal with macroeconomic considerations of the central government, and not to create a system to allow local governments

[1] See Tanzi (1996) for further discussion of the macroeconomic concerns stemming from decentralization.
[2] For example, see Dillinger, Perry, and Webb (1999) and Freire, Huertas, and Darche (1999).

to gain access to credit markets. Indeed, this seems likely to be a reasonable **immediate** goal, given that the pre-conditions for successful local government borrowing are not currently present in Indonesia. However, the **long run** goal must remain the creation of a viable framework in which local governments face hard budget constraints but are still able to have access to capital markets. It is here where the current framework in Indonesia is inadequate. To this end, we suggest a number of policies that will help in a **transition** period from the current reliance on direct administrative control of local borrowing to a greater reliance on market discipline policy.

In the next section, we briefly discuss the current macroeconomic conditions of Indonesia, and outline the major features of Laws No. 22/1999 and 25/1999, including their provisions that deal with local government borrowing. In section III, we present a general "framework" that establishes some conditions under which different approaches to local government borrowing can be successful, and we apply this framework to local governments in Indonesia in the section IV. We conclude in section V.

<u>II. The Indonesian Context</u>

A. Current Political and Macroeconomic Conditions in Indonesia

Indonesia is a country with huge geographic and ethnic diversity. It is rich in natural resources (fisheries, forests, minerals, and mining), which are in most cases located in the outer islands. For many years the central government in the capital city of Jakarta took all significant revenues from all over the regions and then redistributed some of these revenues according to grant formulae based on both population size and geographical coverage. In reality, however, Jakarta enjoyed most of the benefits of these revenues. The striking and widening disparities across the regions, especially between Jakarta and the other regions, created deep resentments from local governments and their citizens outside of Java. This resentment was especially deep in the oil and natural gas provinces such as Aceh, Riau, West Papua, and East Kalimantan, where any potential benefits from the oil revenues were hardly felt.

The economic crisis that began in June 1997 brought down the centralized and authoritarian government of President Soeharto, and lead to a radical political change toward a more democratic system. As discussed in detail below, the transition government under the leadership of President B. J. Habibie shifted decentralization policy also in a radical way, both as a natural response to pressures from local governments (especially from outer Java islands) and as a political maneuver to win the upcoming general election in June 1999. The passage of Laws No. 22/1999 and No. 25/1999 was designed as an extreme response to the previous local autonomy law based mainly on Law No. 5/1974. Despite the absence of many details and the lack also of much consistency with other related laws, these "Big Bang" changes were easily passed by parliament because of both popular pressure and democratic euphoria. Eventually, President Habibie lost in the 1999 elections. However, the decentralization laws were already in place, and it became the responsibility of the new government of President Abdurrahman Wahid, and now President Megawati Sukarnoputri, to implement them.

The economic crisis seriously worsened Indonesia's economic conditions. During 1998, the economy contracted by 14 percent, inflation reached almost 80 percent, the exchange rate depreciated more than 80 percent, and the unemployment and poverty rates more than doubled. All of this was accompanied by the decimation of the financial sector. Compared to other countries in Southeast Asia that experienced the same crisis, there is compelling evidence that Indonesia suffered the most. The crisis forced the Government of Indonesia (GOI) to seek support from the International Monetary Fund (IMF), especially to bail out the banking sector that had collapsed from the very deep exchange rate depreciation and also from the political turmoil that ignited systemic bank runs. During 1998 and 1999, the GOI had to issue domestic-denominated bonds in the amount of Rp. 659 trillion, or about 70 percent of Indonesia GDP, in order to finance its banking restructuring and recapitalization program. This sudden and enormous issue of domestic bonds, together with increasing government external debts to the IMF and other multilateral and bilateral donors, created a huge public debt burden. Public debts jumped from around 45 percent of GDP before the crisis in 1996 to 110 percent in 1999, an increase that raised serious questions regarding the capacity of the national government to manage the fiscal risk and to sustain its government budget.

With such perilous national economic and fiscal conditions, the implementation of the new decentralization policies increased fiscal risk and threatened macroeconomic stability, primarily because of the fear the local governments with their new autonomy would not behave in a fiscally responsible manner and that the central government would be forced to step in. This fear became a dominant consideration when the national government wrote the many regulations to implement the new decentralization laws, especially the local borrowing rules and the revenue sharing mechanisms.

B. The Nature of the Decentralization Reforms

Since the 1950s, Indonesia has been a highly centralized but multi-tier unitary state, with many governmental functions performed by deconcentrated central government agencies in provinces and districts (Shah and Qureshi, 1994; Booth, 1996; Aten, 1999).[3] Before 1999,

[3] It may be useful at the start to clarify some of our terms. "Decentralization" is used here to denote the transfer of significant degrees of authority and responsibility for governmental expenditures and revenues from the central government to lower levels of government. In contrast, "deconcentration" occurs when central government functions are dispersed to central government offices located in provinces, cities, or other local areas, but these

decentralization policy was largely based on Law No. 5/1974, which in its implementation made "local governments" – taken here to include both provincial and district governments - almost totally dependent on the national government. This dependence was not only in terms of financial (or fiscal) support, but also in terms of political power. Expenditure decisions of local governments were generally dictated by the central government, and nearly all local government revenues came from the center. Political dependence on the national government occurred via the appointment process of heads of districts, mayors of municipalities, and governors at the provincial level. Although local government institutions (e.g., the locally elected parliament) held in theory the power to appoint the local government head, in practice the appointment process was decided by a higher level of government. The governor's appointment was made directly by the President, and both the district head's and the mayor's appointments were determined by the governor.

The full implementation of Laws No. 22/1999 and 25/1999 has begun to change this organization of governments, in several fundamental ways.

First, Law No. 22/1999 eliminated the hierarchical relationship between the provincial and the district governments. The district governments - called *kota/kabupaten* – have become more autonomous, so that the heads of these district governments no longer report to the governor of the province. Instead, the district heads are responsible to the locally elected assembly (*Dewan Perwakilan Rakyat Daerah,* or *DPRD*). In contrast, the provinces retain a hierarchical relationship with the central government.

Second, with some limited exceptions (e.g., defence and security, foreign policies, monetary and fiscal policies, judiciary affairs, and religious affairs), Law No. 22/1999 also made

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functions nonetheless remain the responsibility of the central government (Bird and Vaillancourt, 1999). Until the passage of the 1999 reforms, the practice in Indonesia had been largely one of deconcentration, not decentralization.

all deconcentrated central government ministries at the province and the district level the responsibility of the respective local government. In the previous system, the central government and its ministries had deconcentrated departments called a *kepala kantor wilayah*, or *kanwil*, at the provincial level; in some cases, the *kanwil* had a sub-branch at the district (or subdistrict) level called a *kantor departemen*, or *kandep*. The province had its own planning agency (*Bappeda*) and various autonomous "decentralized" departments (or *dinas*) under its own control at the provincial level, generally consisting of departments for own revenues (called a *dinas pendapatan daerah*, or *dipenda*), as well as *dinas* for education and culture, health, public works, traffic management, agriculture, livestock, fishery, forestry, plantations, industry, social welfare, labor, and tourism, all of which have central government counterparts in the deconcentrated *kanwils*; the province also sometimes had branch offices (called *cabang dinas*) at the district level, although this was apparently not that common. Like provinces, districts had an autonomous decentralized department in charge of own revenues (again, called a *dipenda*), and they generally had *dinas* for services like health and public works, although the range of these departments depends upon size and location of the district. Now, the deconcentrated central government departments at the provincial level are the responsibility of the province, and those at the district level have been turned over to the district. When complete, this change promises a major reorganization in the way in which public services are delivered in Indonesia.

Third, Law No. 25/1999 altered the transfers received by local governments from the central government. The routine transfer that was largely used to pay the salaries of local civil servants (the *Subsidi Daerah Otonom*, or *SDO*) was eliminated; also eliminated were general development transfers known as block *Instruksi Presiden*, or block *Inpres*. These two transfers were combined into a general allocation fund (the *Dana Alokasi Umum*, or DAU) whose total amount is specified as at least 25 percent of central government domestic revenues and whose distribution among local governments is made by a formula (McLeod, 2000). Law No. 25/1999 also introduced revenue sharing for provincial and district governments, assigning each level of government its share of revenues from taxes on land and buildings, the transfer of land and buildings, forestry, mining, fisheries, oil, and gas. Other local government sources of revenues (e.g., own source revenues, fees and charges, profits from government enterprises) were largely unchanged, as were revenues from specific *Inpres* grants used to finance development projects in areas such as primary schools, health facilities, water supply, and roads; this feature of the decentralization is discussed in more detail later.[4] Borrowing by local governments is to be permitted from within Indonesia, although the IMF remains quite uncomfortable with this outcome. It is this feature that we focus upon later. Table 1 summarizes the changes in local government revenues from the passage of Law No. 25/1999.

Table 1. Sources of Local Government Revenues

Before Law No. 25/1999	Under Law No. 25/1999
1. Fiscal Transfer From Central Government: a. Regional Autonomous Subsidy b. *Inpres* Grants (for village, district, and provincial governments) c. Revenue Sharing of Property Tax (on land and buildings)	1. Fiscal Transfer from Central Government: a. General Block Grant b. Specific Grant c. Revenue Sharing from Natural Resources and Property Taxes
2. Local Own-revenues: a. Local Taxes and Retributions (Law No. 18/1997) b. Revenues from Local State-owned companies	2. Local Own-revenues: a. Local Taxes and Retributions (Law No. 32/2001) b. Revenues from Local State-owned Companies
3. Local Borrowing	3. Local Borrowing

[4] Provincial taxes consist mainly of a tax on motor vehicles, on the transfer of motor vehicles, and on motor vehicle fuel. District taxes include the hotel and restaurant tax, the entertainment tax, the advertising tax, the street lighting tax, the mineral tax, and the water use tax. Under the plan, the major provincial taxes are being transferred to district level. Changes made to the Indonesian constitution in the middle of year 2000 include the potential that the profits of state-owned enterprises located in decentralized regions will be shared with those regions; in addition, 20 percent of the individual income tax will be shared by the national government. As most income tax for employed persons is collected under the corporate income tax, this latter change is not as significant a concession as might be thought.

Until recently, most local governments in Indonesia still depend very heavily on transfers from the national government. The new revenue sharing formula gives a huge increase in revenues for local governments with rich natural resources, especially in oil, gas, mining, and forests, and for city governments with a relatively developed economy. Under this new formula, it is expected that the disparities across provincial and districts governments will widen, especially since the capacity of the central government to lessen these disparities has been significantly reduced by the economic crisis.

Local own-revenues remain very limited. As shown in Table 2, the importance of local own-revenue in financing local government spending is only around 20 percent for most provincial governments and less than 10 percent for district governments. Local taxes and retributions are based here on the new law of local government revenue, Law No. 32/2001, which replaced Law No. 18/1999. Under the new law, local governments still have very limited locally controlled sources of taxes. Nonetheless, many local governments are currently increasing their efforts to raise local revenues, by introducing many new local taxes, retributions, and fees. Such efforts have generated many complaints from businesses and investors.

Table 2. The Importance of Local Own-revenues in Total Local Expenditures

Ratio of Local Own-revenues to Total Local Expenditures	Number (Percent) of Provincial Governments	Number (Percent) of District Governments
< 10%	3 (11.1%)	156 (51.1%)
10% to < 20%	4 (14.8%	86 (29.2%)
20% to < 30%	11 (40.7%)	0
30% to < 40%	6 (22.2%)	14 (4.6%)
40% to < 50%	1 (3.7%)	8 (2.6%)
50% and above	2 (7.4%)	2 (0.7%)
Total	27 (100%)	305 (100%)

Source: LPEM-FEUI (1999)

Faced with serious constraints on their sources of revenue, local governments will naturally look for other sources of finance, especially given their new and increased responsibilities. An obvious option is local borrowing. Under Law No. 25/1999, local governments are allowed to borrow to finance their deficit. However, the experiences of many other countries suggests that, without proper control and management, local borrowing can create a serious threat to prudent fiscal policy and thereby lead to macroeconomic destabilization.

In sum, the two decentralization laws are transforming intergovernmental relations in Indonesia. In particular, and together with the 1999 elections held at the province and district levels, the laws and the related implementation process have the potential to increase significantly the accountability of local government officials. It is through this accountability that the major advantage of decentralization is obtained: moving government closer to the people (Oates, 1972, 1999). Because of Indonesia's democracy reforms, the leaders of the local governments - the governor at the provincial level, the bupati at the *kabupaten*, and the mayor at the *kota* - are now being chosen by the respective elected parliaments (although not directly by the voters), rather than appointed from above. As a result, their first responsibility is more directed downward to the elected assembly and then upward to the central government. The assignment of significant new expenditure responsibilities to provincial and, especially, to *kota/kabupaten* governments has the potential to achieve the efficiency gains that come when governmental decisions are more responsive to the wishes of its citizens, so that public services are provided in amounts that correspond more closely to the preferences of the individuals in those jurisdictions, rather than at uniform national levels. Other potential gains include greater revenue mobilization because citizens may be more willing to pay local taxes to provide local public services and because local governments may be more familiar with, and so better able to tax, local tax bases. Overall, the decentralization laws and regulations are meant to carry out a proper sorting of the assignment of expenditure responsibilities. The ongoing process of implementation of the laws has the potential and eventual likelihood to generate significant gains for the people of Indonesia.

However, despite these potential benefits, the new decentralization laws and the implementing regulations also exhibit some crucial limitations.[5] The laws are not accompanied by any well-articulated goals that their implementation is intended to achieve; indeed, the entire process by which the decentralization has proceeded seems ill-defined. The laws themselves lack many specific details that their implementation will require and that are being addressed in the implementation process. Of special importance here, the laws also fail to address many aspects of local government borrowing. Issues related to borrowing are discussed next.

C. Local Government Borrowing

Most local borrowing over the past twenty years has been carried out under central government mechanisms. Even so, the extent of borrowing has been quite modest, less than 0.5 percent of GDP; of this, most borrowing has been undertaken by the regional water authorities (PDAMs). The terms of central government loans have been very favorable to borrowers, with extensive grace periods, long terms to maturity, and significantly subsidized interest rates. Nevertheless, the repayment of loans has been poor, and at the end of 1999 the arrears rate was over 40 percent. Table 3 has some basic information on local government (and local enterprise) borrowing over the past two decades, as calculated by Lewis (2003).

Table 3. Regional Borrowing (in Rp billions), 1978 to 1999

Borrower	Number of Loans	Disbursements	Arrears	Arrears Rate
Province	82	841.0	10.1	0.029

[5] See Alm, Aten, and Bahl (2001) for a detailed discussion of these issues.

Kota	115	513.8	181.6	0.553
Kabupaten	193	228.8	39.4	0.443
PDAM-Kota	187	2,151.3	481.3	0.470
PDAM-Kabupaten	237	865.0	130.9	0.599
Total	814	4,599.9	843.3	0.419

Source: Lewis (2003).

Before the political transition in 1998-1999, local government borrowing was controlled very tightly by the central government under Law No. 4/1974. Under this law, regional governments were permitted to borrow only with the approval of the Minister of Home Affairs, who put limits on the amount that could be borrowed and also gave approval on the specifics of the borrowing proposal.

During this period local governments were faced with increasing pressures for local borrowing, based in part on greater demands for urban services stemming from accelerating urbanization. In 1985 only 26.4 percent of the population in Indonesia (or about 43 million people) lived in urban areas; within ten years the urban population had increased to 65 million people; by the year 2000 roughly one half of the population – nearly 100 million people – were projected to reside in urban areas. This population growth created huge demands for new capital facilities. However, under Law No. 4/1974, almost all investments in urban infrastructures (e.g., roads, bridges, schools, and health facilities) were chosen, funded, and managed by the central government through *Inpres* funding. With a negligible role played by local government and its citizens in this process, the result was often inefficient project choices, lack of local ownership and responsibility, and conflicting priorities with local government development programs.

There have been various efforts over time to integrate more fully local governments in the decision process of regional (urban) investment. One was made in 1985 with the establishment of the Integrated Urban Infrastructures Development Program (IUIDP). Among other things, this program changed the borrowing limit from no more than 15 percent of the Debt Service Ratio (DSR), to an alternative and more lenient rule based on a Debt Coverage Ratio (simply the reciprocal of the DSR) of less than 1.5. The program also changed the terms and sources of borrowing. Overall, however, the IUIDP was largely unsuccessful, mainly because the central government continued to dominate all stages of the decision process.

In 1988 the national government established the Regional Development Account (RDA) as a further effort to unify the system of local borrowing in terms of process, lending, and repayment requirements. This account was under the Ministry of Finance, was run by the Director General of Financial Institutions, and was put in operation after the Director General of Financial Institutions created a formal account in the central bank (Bank Indonesia account number 519.000.102). The RDA was intended to help make the transition from the previous system of local borrowing policy to a more market-based system, by establishing an institution (and an account) that was a pure lending and intermediary institution. The role of local government in borrowing was expected to increase and gain in importance, accompanied by an improvement in the capacity of local governments to plan and manage their investment projects and to mobilize their own revenue sources to repay their borrowing. However, the sources of funds of RDA were still primarily from the general budget of the central government and from foreign government loans, and only a very small portion (e.g., less than 10 percent) of the RDA actually came from RDA repayment. With this narrow funding source, as well as with other administrative difficulties, the RDA was largely unable to respond to the demand for funds. Even after almost ten years, the RDA failed to transform local government borrowing practices in Indonesia to a more market-based approach.

Overall, the previous policy on local government borrowing relied heavily on administrative controls, which covered the total amount of allowable borrowing, the criteria for and purposes of borrowing, and the approval process. The dominant source of local borrowing in the past came from the central government budget via the RDA, and also from foreign government donors via the Subsidiary Lending Agreement (SLA) and the SLA with Pre-financing (SLAP). Both domestic and foreign loan sources were managed by the Ministry of Finance under the Director General of Financial Institutions. The consequence of such centralized control was a complex, long, and inefficient loan procedure that severely restricted the annual budgeting process of local governments.

It is nonetheless striking that, despite this centralized control, the borrowing terms given to local government were seldom uniform. For example, local governments often faced different diff interest rates. The rate from the RDA was determined annually as the most recent inflation plus a small margin; the SLA interest rate was similar to the central bank's 6-month certificate, as representative of the market rate. Both loans imposed a fixed interest rate, but there were exceptions (e.g., the Surabaya Urban Development Project, which used a variable rate subject to a maximum 14 percent interest rate). There were also different commitment fees. The RDA charged 0.75 percent on any shortfalls of loan withdrawal under the plan; in contrast, the SLA financed by the Asian Development Bank (ADB) charged 0.25 percent on the same base as the RDA, and the SLA from the World Bank was officially 0.75 percent but in practice was 0.25 percent based on the undrawn balance of the entire amount of the loan. Similarly, the grace and repayment periods varied considerably. The SLA gave a 5-year grace period and 15 years for repayment. The RDA grace period was a maximum of 5 years, with a 3-year minimum common practice, and its loan repayment was a maximum of 20 years (including the grace period).[6] Finally, the loan criteria, the conditionalities, and the restrictions that were applied under past borrowing policy also varied considerably. There were no common economic and financial feasibility standards applied in deciding the loan approval, and, despite the presence of a financial report, there were no significant conditionalities applied for RDA loans, and only some SLA loans required a financial covenant on the principal loan agreement. Both RDA and SLA loans were intended only for investment financing, but the RDA put restrictions for direct cost recovery of investment, while the SLA did not apply any restrictions.

Some efforts were made during the mid-1990s to move local borrowing policy from a heavy administration control to a more regulatory based or even a market-based mechanism. However, in order to achieve this objective, central government needed to transform the RDA and SLA borrowing mechanism from their previous practices by imposing more prudential financial principles that mimicked market discipline. This required improving and applying a standard government accounting system on loan and debt repayment records, adopting a uniform lending policy, adjusting interest rates to market rates, and applying transparent and consistent (economic and financial) feasibility studies for loan approval. Fundamentally, such adjustments required a change in the institutional setting of loan mechanism and management.[7] However, the progress of these efforts was very slow because of the economic and political crisis.

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[6] In principle, the grace period should be based on the period in which the project has not been able to generate cash or is still under construction, while the total time of debt repayment should not exceed the average economic life of the project. Both RDA and SLA finance did not follow this principle. The past policy also allowed the local government to defer interest payment during the grace period, a policy that encouraged the borrower to give a low priority for this obligation and even to defer it.

[7] For example, loan administration could be delegated to a regional development bank (*Bank Pembangunan Daerah*), while loan approval and budgeting authorization could still be controlled by the central government. These changes would shorten the administrative process, while continuing to provide discipline on financial criteria and controlling macroeconomic/fiscal risks.

With such these somewhat unsatisfying experiences in local government borrowing policy in its past, and in the current macroeconomic and decentralization setting, the GOI has recently shifted to a new policy toward borrowing. On balance, local borrowing policy in Indonesia has changed in a mixed direction since the new laws of decentralization were passed in 1999 (Table 3). Broadly speaking, under Law No. 25/1999 local governments are given substantial latitude to borrow from domestic sources, and from foreign sources through the central government. Long-term borrowing (e.g., more than one year) is only allowed for investment spending to build infrastructure than can generate revenue for repayment. Short-term borrowing is permitted but only for the management of local government cash flow, and must be repaid by the end of the current year**.**

Table 3. Local Borrowing Before and After the Decentralization Policy

Before Decentralization	After Decentralization
Legal Foundation	
• Law No. 5/1974	• Law No. 25/1999 • Government Regulation No. 107/2000
Institutional Setting	
Approval • Ministry of Home Affairs - imposed a maximum limit and gave approval • Ministry of Finance - supervised the RDA and its approval	*Approval* • Ministry of Finance • Local Parliament
Limits on Borrowing • 1982: DSR <15% • From Implementation and Decree MOH No. 96/1994: Minimum DCR=1 Average DCR > 1.5	*Limits on Borrowing* • Accumulated maximum < 75% general revenue of previous budget • DCR >2.5 for lifetime of project • Maximum short term borrowing 1/6 of current spending
Sources of Funding	
• Foreign Government Lending • Central Government Investment Funding (RDI) • Central Government Equity financing (PMP)	*Domestic Sources* • Central Government • Banks • Non-bank Financial Institution • Households

• Central Government INPRES for Building Market • Down Payment IPEDA • Others Sources (Regional Banks and Private Sources) • Central Government RDA	• Other Sources *Foreign Sources* • Bilateral Sources • Multilateral Sources

These general provisions are discussed in greater detail in the implementing regulations (No. 107/2000). These regulations include:

- Sources of funding
    - Domestic sources of funds include both government and private sources, including banks.
    - Foreign sources can only from government sources (bilateral and multilateral).
- Objective of borrowing
    - Long-term borrowing is permitted only for capital investments that build infrastructure.
    - Short-term borrowing is permitted only for cash flow management.
- Terms of requirement and limitation
    - Maximum cumulative debts cannot exceed 75 percent of total general revenue of local government.
    - Debt Service Coverage minimum is 2.5.
    - Short term borrowing in total cannot exceed 1/6 of total current local government spending and repayment should be made within the current year.
    - Under special circumstances, the Minister of Finance can decide on another limitation for the maximum borrowing (Article 8 (2)).
    - The central government can prohibit local governments from giving a guarantee/collateral based on local government assets.
- Approval
    - Any borrowing from sources other than the central government requires the approval of the local parliament.
    - Any borrowing from central government sources requires the approval of the Minster of Finance.
    - Foreign borrowing can only be done through the central government.

In principle, the new fiscal decentralization law (Law No. 25/1999) gives substantial freedom for local governments to borrow. This new freedom has raised concerns about how local governments will respond. Local governments face huge pressures and demanding tasks in managing their budgets under the new fiscal decentralization. However, the capacity of local governments to manage their budgets – and their borrowing – has not changed. Given the high and unsustainable public debt (e.g., in excess of 100 percent of GDP), there are significant fiscal and macroeconomic risks that severely constrain the ability of the Indonesian economy to sustain additional borrowing even at the local level. In combination with the limited capacity of local governments and the continuing economic crisis, there are pressures on the central government to restrain local governments in their borrowing.

In practice, therefore, the central government has maintained very strict limitations on local government borrowing. The central government has issued a government regulation on local borrowing (No. 107/2000), which imposes very restrictive rules on local borrowing. For example, maximum accumulated debts must be less than 75 percent of general revenues from the previous budget, the debt service coverage ratio must be at least 2.5, and maximum short-term borrowing is 1/6 of current spending. Borrowing must also be approved by either the central government via the Ministry of Finance or by the local parliament (depending on the source of borrowing), and commercial/private foreign borrowings are not allowed. Even after imposing these regulations, the central government still felt the necessity – supported strongly and explicitly by multilateral institutions such as the IMF and the World Bank – twice to delay the implementation of the local government borrowing regulations. The first delay was issued in 2001 (No. 99/KMK.07/2001), and more recently the Minister issued decree No. 625KMK.01/2001, which further delays the implementation of local borrowing regulation until the end 2002.

III. International Experience with Local Government Borrowing: A Framework for Analysis

As emphasized earlier, local government borrowing has the potential to generate significant benefits, by allowing local governments to synchronize unexpected swings in expenditures and revenues, and by allowing them to finance public capital projects that are lumpy in nature. However, there is little doubt that the notion of local government access to credit markets creates substantial uneasiness in many quarters, in large part because the central government has often been drawn into the process, thereby creating significant moral hazard problems. In some cases, the central government itself provides credit, either directly via central government funds or indirectly via intermediaries. However, it is now becoming more common for private sources to provide local government access to funds. The use of private financing requires the development of mechanisms to ensure that the central government is not exposed to the risk of excessive local government debt. The practice in most all countries is that local government borrowing is subject to a variety of controls.

As suggested by Ter-Minassian (1996) and Ter-Minassian and Craig (1997), these controls can be classified into four main categories (Table 4). The first is a reliance on **market discipline**. Here the central government largely stays out of any involvement with local government borrowing, and instead assumes that market forces will ensure that local government debt is managed, controlled, and disciplined. However, as emphasized by Lane (1993), markets will only be effective in providing appropriate discipline if several conditions are met: there should be free and open markets, information on local government current debt and repayment capacity should be readily available, there should be no expectation that local governments will be bailed out, and there should be appropriate institutions in place to ensure that local governments respond to market signals before default or exclusion from credit markets (e.g., political accountability, local own-source revenue capacity). Although there are examples of developed countries that rely primarily on this approach – Canada, Finland, France, Portugal, and Spain – these conditions are seldom met even in developed countries, and are especially rare in developing and transition countries.

Table 4. Local Government Borrowing Controls in Selected Countries

	Market discipline		Cooperative control		Rule-based control		Direct Administrative control		Borrowing prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Industrial countries										
Australia			•	•						
Austria							•	•		
Belgium			•	•						
Canada	•	•								
Denmark			•	•						
Finland	•	•								
France	•	•								
Germany					•	•				
Greece							•	•		
Ireland							•	•		
Italy					•	•				
Japan								•	•	
Netherlands					•	•				
Norway							•	•		
Portugal	•	•								
Spain							•	•		
Sweden	•	•								
Switzerland					•	•				
United Kingdom							•	•		
United States					•	•				
Developing Countries										
Argentine				•			•			
Bolivia				•			•			
Brazil				•			•			
Chile				•			•			
Columbia				•			•			
Ethiopia								•	•	
India							•	•		
Indonesia							•	•		
Korea, Rep. Of							•	•		
Mexico								•	•	
Peru							•	•		
South Africa			•	•						
Thailand									•	•
Transition economies										
Albania									•	•
Armenia									•	•
Azerbaijan									•	•
Belarus									•	•
Bulgaria									•	•
China									•	•
Estonia							•	•		
Georgia									•	•
Hungary							•	•		
Kazakhstan									•	•
Kyrgyz Republic									•	•
Latvia							•	•		
Lithuania							•	•		
Poland									•	•
Romania									•	•
Russian Federation	•	•								
Slovenia									•	•
Tajikistan									•	•
Ukraine									•	•
Uzberkistan									•	•

Source: Ter-Minassian (1996) and Ter-Minassian and Craig (1997).

At the other extreme is **direct administrative control** of local government borrowing, in which the central government directly controls borrowing via such methods as limitations on the debt of individual local governments, restrictions (or bans) on external borrowing by local governments, required approval of specific local government investment projects and their terms of finance, and centralized control on all local government borrowing. This approach is often found in developed countries (e.g., Austria, Greece, Ireland, Japan, Norway, Spain, United Kingdom), and is also common in developing and transition countries, such as Argentina, Bolivia, Brazil, Chile, Colombia, Ethiopia, India, Republic of Korea, Mexico, Peru, Estonia, Hungary, Latvia, and Lithuania. The advantages of this approach are several, especially regarding external borrowing. The central government should be able to coordinate overall country debt policy without undue concern that local government actions will be counterproductive, and it may be able to obtain better terms on external debt than it could otherwise. However, this approach also necessarily involves the central government in the micro-management of local government investment decisions, contrary to the principle of subsidiarity.

In between these two extremes are several other approaches. One intermediate type is **cooperative control**, in which any limitations on local government borrowing are generated via a negotiation process between the central government and local governments. During the negotiations, agreement is reached between the different levels of government on such issues as overall deficit targets and revenue and expenditure growth, with controls on local government debt emerging as byproducts of these broad goals. This approach is closer to the market discipline end of the spectrum than to the direct administrative control end. Belgium, Denmark, and, especially, Canada are examples of developed countries that rely mainly – and successfully

– on such a cooperative approach to debt control. However, its effectiveness seems to depend on the prior existence of a "culture" of cooperation and fiscal discipline. In the absence of this culture, this approach is unable to prevent excessive debt, as shown by the experience of such countries as Brazil and Colombia. More generally, the conditions for its success are unlikely to be found in many developing and transition countries.

Another intermediate approach to debt control is what might be termed **rule-based control**. Here the actions of local governments are proscribed in various rules written into the constitution, law, or regulations. These rules may establish limits on the level of allowable local government debt, they may specify rules similar to market-based approaches like limits on debt-service capacity, they may stipulate that borrowing can only be used for particular kinds of expenditures (e.g., capital projects), they may specify that borrowing for non-investment purposes be repaid at the end of the fiscal year, and they may prohibit certain kinds of borrowings. The rule-based approach is transparent, and it treats all local governments equally. However, it necessarily introduces an element of inflexibility, and it gives local governments an incentive to devise schemes that attempt to avoid or evade the rules.[8] Its success depends crucially on the ability of the central government to monitor compliance with the rules (e.g., accounting standards, financial information systems).

On balance, it seems clear that reliance on either of the two extreme methods of control – market discipline and direct administrative control – is not appropriate for developing countries pursuing fundamental decentralization reforms, such as Indonesia. Reliance on markets to discipline local governments requires pre-conditions that are unlikely to be met in Indonesia, and the exclusive use of direct administrative controls is inconsistent with the recent decentralization

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[8] These schemes are well-known, and include such actions as reclassifying current expenditures as capital expenditures, creating off-budget agencies and even government-owned enterprises, and relying on payment via arrears.

laws that attempt to give more autonomy to local governments. The cooperative approach also seems inapplicable to most developing countries, including Indonesia, given the absence of the "culture" of cooperation and fiscal discipline required for its success. Instead, the approach that seems best able to combine the benefits of local government autonomy with the required limitations on local government behavior is the rule-based control.

However, regardless of the specific approach that is used, any well-designed regulatory framework depends upon several required elements: transparency (especially through better information systems and standardized accounting procedures), penalties for excessive borrowing (including bankruptcy provisions), local government access to own-source revenues, the separation of fiscal from financial systems, and local government accountability via the political process. There also needs to be scope for change, as circumstances and capabilities evolve.

It is of some note that the extent of local government borrowing is quite variable but generally remains low. Table 5 gives some selected information on the relative reliance of local governments on borrowing as a source of own-source revenues.

Table 5. Local Government Reliance upon Borrowing in Selected Countries

	Share of Borrowing in Local Government Revenues (percent)
Industrial Countries	
Austria	8
Belgium	0
Cyprus	12
Denmark	0
Finland	6
France	9
Germany	9
Greece	4
Iceland	0
Ireland	5
Italy	7
Luxembourg	9
Netherlands	0
Norway	0
Portugal	7
Spain	13

Sweden	0
Switzerland	4
Turkey	0
United Kingdom	8
Developing Countries	
Ghana	0
Malta	0
San Marino	69
Senegal	2
Swaziland	4
Uganda	0
Zambia	0
Zimbabwe	3
Transition Economies	
Albania	0
Bulgaria	3
Czech Republic	10
Estonia	3
Hungary	7
Latvia	0
Lithuania	0
Macedonia	0
Poland	0
Romania	0
Russian Federation	0
Slovakia	4
Slovenia	0

Source: Selected publications.

IV. Applying the Lessons to Indonesia

In this section, we apply these lessons from international experience to Indonesia. In particular, we first attempt to estimate the potential local government borrowing capacity. In this regard, the demand for local government borrowing is expected to grow rapidly in the near future because local governments are undertaking more functions and responsibilities under Law No. 22/1999 and, even aside from the decentralization, there are increasing pressures for public services from a rapidly urbanizing population. There will also be upward pressure on investment spending because of the transfer of financing of activities known as the DIK/List of investment activities from the center to local governments under the autonomy laws. Recall also that local governments are permitted to borrow short-term to deal with cash-flow issues in their current budgets; such cash-flow problems could arise from routine expenditures for staff salaries because of the transfer of personnel from central to local governments. However, in the face of these demands, the revenue sources for local government are still limited due to the assignment of few productive tax bases to local governments and to the weaknesses of local tax administration.[9] In response, local governments will face increasing pressure to borrow funds. It is therefore of some interest to have estimates of their borrowing capacity.[10]

Under Law No. 25/1999, local governments are allowed to borrow, under some specified administrative restrictions. Based on this law and the borrowing restrictions, LPEM-FEUI has made estimates of local government borrowing capacity for the year 2001. These estimates are based on projections of both revenue and expenditure.

Projections of the revenue side are based upon the following assumptions and procedures:

- Local-own revenues are estimated using their annual performance in 1999/2000.
- Revenue sharing from natural resources is based on Ministry of Finance calculations, which project distributions to local governments in 2001.
- Revenue sharing of property taxes and acquisition fee is estimated using LPEM-FEUI simulations.
- The general grant allocation is estimated using the LPEM-FEUI model, which will be used as a grant allocation formula in the government regulation.
- Provincial governments are assumed to receive revenue sharing from the income tax (20 percent), which is not shared with district and city governments.

Projections on the expenditure side use the following assumptions:

- Routine expenditure is estimated using the figure for 1999/2000.
- Investment spending is calculated using the DIK/List of investment activities that was submitted by local governments to the central government for the fiscal year 1999/2000.

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9 As discussed earlier, local government revenues mainly come three sources: fiscal transfers from the central government (e.g., general block grants, specific grants); revenue sharing from natural resources (oil, gas, forestry, mining, fishery), the property tax (PBB), and user fees (BPHTB); and local own-source revenues.

10 An effort within the Ministry of Finance has been made in the past to estimate local borrowing capacity under the old law of local autonomy, in order to assess demands on RDA funds, as well as applications for RDA loans and for SLAP arrangements under World Bank urban development projects in East Java, Bali, Sulawesi, and Irian Jaya. However, these models have not been endorsed by the Ministry of Home Affairs.

The difference amount between projected revenues and expenditures is divided by 2.5 (or the Debt Service Coverage Ratio), and is assumed to equal the amount available for borrowing, repayment, interest, and other costs of borrowing. The total maximum borrowing is then estimated using the amount available for payments of principal, interest, and other costs of borrowing over the maturity period of borrowing (8, 10, and 12 years). The amount of borrowing allowed can be calculated by subtracting outstanding borrowing from total maximum borrowing.

The estimation results are shown in Table 6. Under the current law, and based on past performance in borrowing, most local governments in Indonesia have wide room to initiate new borrowing. More than 80 percent of provincial governments, almost 95 percent of district/ kabupaten governments, and roughly 50 percent of city governments have the ability to borrow above Rp 10 billion.

Table 6: Local Government Borrowing Capacity in Indonesia

	Provincial Government		**Kabupaten Government**		**City Government**	
Ability to Repay (in Rp)	Number	%	Number	%	Number	%
> 100 billion	5	19.2	22	9.5	2	3.3
10 – 100 billion	14	53.9	171	73.7	17	28.3
< 10 billion	2	7.7	27	11.6	11	18.3
Not allowed to borrow	5	19.2	12	5.1	30	50.0
Total	26	100	232	100	60	100

Source: LPEM-FEUI (2000).

However, as emphasized earlier, the presence of enormous public debt, the continuing macroeconomic crisis, and ongoing concerns about the capacity of local governments to manage their budgets (and their debt) have led the central government to restrain severely local governments in their borrowing. The central government has maintained very strict limitations on local government borrowing, and has even twice delayed the implementation of even these strict regulations. In the conclusions, we assess these new limitations.

V. Conclusions

There are clearly **immediate** short-term macroeconomic justifications for restricting local government borrowing, especially in the current economic environment. However, it must be recognized that such strong restrictions also impose significant difficulties on local governments. These restrictions will create limited opportunities and even less motivation for local governments to develop the necessary skills to improve their borrowing skills. They will impose significant barriers for local governments in gaining funds directly from the capital markets. They will likely contribute to longer and more uncertain periods of project execution, something that is especially true when approval of projects requires political approval from both the local parliament and the central government. The restrictions will reduce the ability of local governments to respond to the wishes of their constituents in a timely and effective way. The intimate involvement of the central government in the entire process of local government borrowing may well expose the central government to high contingent risks, especially when the debts are defaulted and the central government is asked to bail out the debt failures. The constraints will also create negative impacts on the development of needed capital market infrastructure for local borrowing.

In order to reduce these negative impacts, we believe that the central government must design a clear, realistic, and well-planned **transition** period to adjust from the current reliance on direct administrative control of local borrowing to a greater reliance on market discipline policy. The transition should cover the following activities and actions:

- Improving and implementing a government accounting system for fiscal management, including maintaining a full borrowing record and reporting.
- Imposing requirements of local borrowing that replicate market discipline (e.g., a proper and accurate feasibility study, a non-subsidized interest rate, grace and repayment periods that represent the real project life, financial covenants that capture realistically the risks and the revenue flows of the project).
- Diversifying – gradually - the sources of any local borrowing fund, using less reliance upon the central government budget and foreign government borrowing, and greater reliance on private market sources.
- Creating regulations and building competent institutions to support, facilitate, supervise, and safeguard the work of an efficient and prudent local borrowing market.

In short, the **long run** goal must remain the creation of a viable market-oriented framework in which local governments face hard budget constraints but still have access to credit markets.[11]

[11] For a detailed discussion of how to create local credit systems, see especially Peterson (2000) and Noel (2000).

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